

C O N F I D E N T I A L SECTION 01 OF 03 TAIPEI 000385

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SUBJECT: US-CHINA TRADE IMBALANCE (C-AL5-00044)

REF: A. STATE 11139  
B. 04 TAIPEI 3930

Classified By: AIT Director Douglas H. Paal, Reason 1.5 (d)

Summary

**¶11. (U)** Taiwan export manufacturing firms have made massive investments in the PRC, with especially strong 50 percent growth in investment during 2004. In the key industries of electronics and information technology products manufacturing, a pattern of triangular trade has emerged. Taiwan firms export high-tech components to Taiwan-owned factories in the PRC. Then Taiwan firms fill U.S., European and Japanese export orders for finished consumer goods from their PRC assembly plants. As a result, Taiwan's exports to the U.S. have fallen overall the last few years. Notebook PC manufacturers have invested heavily and rapidly in the PRC. Nearly 100 percent of laptop PC's produced by Taiwan firms will be assembled in the PRC in 2005. The industry saw a particularly strong fourth quarter with fierce competition cutting costs and driving up demand. Taiwan's investment in the PRC in the telecommunications equipment industry has not been as strong. The PRC factories account for just 28 percent of cell phones manufactured by Taiwan firms. (End summary.)

Triangular Trade Pattern

**¶12. (U)** Although not an action addressee on ref A, AIT would like to provide input on the questions raised about the rapid increase in China's exports to the United States. Investment by Taiwan firms in the Mainland has been massive. Taiwan figures, based on applications for investment approved by the government, put total investment since 1991 at over USD 41 billion. This does not include substantial investment funneled through third territories, which is widely thought to exceed officially approved investment by a factor of 2, 3 or even 4. After two years of strong growth, Taiwan's investment in the PRC surged in 2004. Taiwan government statistics show that investment in the PRC rose by 38.6 percent in 2002 and 19.1 percent in 2003 over the previous years, but then increased again by a remarkable 51.2 percent to USD 6.94 billion in 2004. Growth in the first half of 2004 was even more striking at 68 percent compared to the same period in 2004. Most of Taiwan's investment in the PRC has involved the transfer of manufacturing and assembly operations to the Mainland and then exporting the output to the U.S., Europe and Japan.

**¶13. (U)** Electronics and information technology (IT) have played an increasingly important role in cross-Strait trade and investment (ref B). Taiwan firms now dominate the PRC's IT export industries. The Market Intelligence Center (MIC), an industry research firm, estimates that Taiwan firms accounted for 79 percent of total PRC IT output (excluding software) in 2004. In these industries a pattern of triangular trade has emerged. While moving less advanced assembly operations to the PRC, Taiwan has maintained a base on the island for manufacturing high-tech components, including semiconductors and flat-panel display components. These kinds of components and other manufacturing inputs account for 80 percent of Taiwan's exports to China. After export to the PRC, the components are mostly re-exported in finished consumer goods to the U.S., Europe and Japan. Given this trade pattern, it is not surprising that the PRC's trade surplus with the United States -- USD 71.5 billion in the first 11 months of 2004 -- mirrors the PRC's combined deficit with Taiwan and South Korea -- USD 78.6 billion during the same period.

**¶14. (U)** With increasing investment in the PRC, Taiwan's exports to the U.S. have generally fallen as trade is routed through production bases in the Mainland. Although last year saw Taiwan's exports to the U.S. rise 8.4 percent to USD 28.1 billion, this increase followed three years of decline. Total 2004 exports to the U.S. still fell almost 20 percent below the 2000 figure. The gap between U.S. purchase orders for Taiwan firms and Taiwan exports to the U.S. illustrates the nature of triangular trade between the U.S., Taiwan and the PRC. In December 2004, Taiwan export shipments to the

U.S. totaled USD 2.5 billion, only 42.5 percent of the USD 5.8 billion in purchase orders Taiwan firms received from the U.S. during the month. Most of the difference is filled with products assembled in the Mainland. Strong growth in U.S. orders to Taiwan firms in the fourth quarter of 2004, which were 32 percent higher than the previous year, may translate into more strong PRC export growth in the first or second quarter of 2005, depending on when the orders are shipped.

Notebook PCs ) Rising PRC Investment and Export Demand

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15. (C) The transfer of manufacturing from Taiwan to the Mainland in the notebook computer industry has been dramatic. A recent MIC study estimates that nearly 100 percent of laptops produced by Taiwan firms in 2005 will be assembled in the PRC. Taiwan firms produce most of the world's laptop PCs. Quanta Computer Inc. alone accounted for 25 percent of the global market in 2004 and has announced that it is aiming for 30 percent in 2005. Its top two Taiwan rivals Compal and Wistron together accounted for almost 25 percent in 2004. Quanta's transfer of production to the Mainland has been astonishingly rapid. Early in the first Chen Shui-bian administration, Quanta's founder and CEO Barry Lim had been vocal about keeping manufacturing in Taiwan. However, price pressures and the migration of its suppliers to the Mainland forced Quanta to begin manufacturing operations in the PRC in 2001. Deputy Group Spokesman Jason Lin told AIT that 85 to 90 percent of Quanta's 2004 third quarter notebook production was based in the Mainland. That figure increased to 95 percent in the fourth quarter and is predicted to approach 100 percent in 2005.

16. (SBU) In addition, the notebook computer industry saw unexpectedly high demand in the fourth quarter of 2004. Quanta shipped 3.7 million notebook PCs in the fourth quarter, up 32 percent from the previous quarter. Low prices due to fierce competition among manufacturers were a major contributing factor to high demand. The current average gross margin for the industry is just 5 percent and expected to fall below 4 percent according to MIC. Executives of Quanta and Compal have called publicly for an end to the price war, which is driving down stock prices. About one-third of the laptops produced by Taiwan firms in the fourth quarter was shipped to the U.S. Another third was shipped to Europe, and one quarter of shipments went to Asia, excluding the PRC.

17. (U) Nevertheless, the MIC study predicts that laptop shipments will drop by 14.7 percent in the first quarter of 2005 to a total of 10.4 million units. This is due in part to a shortage of key components, including Intel's Celeron central processing unit. Quanta Chief Operations Officer Michael Wang suggested to AIT/T earlier this month that we urge Intel to sell them more components.

Cell Phones ) Smaller but Significant PRC Investment

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18. (U) Taiwan manufacturers of telecommunications equipment, and cell phone handsets in particular, have not invested as heavily in the Mainland as some other electronics industries. According to research by Taiwan's semi-official Industrial Technology Research Institute (ITRI), 61 percent of cell phone manufacturing by Taiwan firms takes place in Taiwan. This may in part be driven by continuing restrictions on the import of cell phones into Taiwan from the PRC, even as other categories of electronics have been liberalized. Nevertheless, with 28 percent of production in the PRC, cross-Straits investment has been substantial. Furthermore, this figure does not capture some Taiwan investment that takes place through third territories.

19. (SBU) BenQ is Taiwan's number one cell phone brand, a leading contract manufacturer for other brands, and the largest cell phone manufacturer both in Taiwan and the PRC. David Huang, BenQ's Financial Planning Department Senior Manager, told AIT/T that his firm has been transferring manufacturing operations to the PRC for over ten years. According to Huang, neither BenQ nor its major Taiwan competitors opened new factories in the PRC during the last half of 2004. However, he notes that production capacities at their manufacturing plants in China are scaleable, allowing BenQ and other manufacturers to quickly expand production without large-scale capital investment.

10. (C) Huang also said BenQ products manufactured in the PRC are exported in nearly equal amounts to the United States, Europe and Asia (excluding China), each accounting for about 30 percent of sales. The remaining 10-13 percent is produced for the China market. For all Taiwan cell phone manufacturers, North America accounted for 26.1 percent of 2004 sales, according to ITRI. Europe and Japan accounted for 30.4 percent and 7.5 percent respectively. Huang noted that as in laptop manufacturing, competition in the cell phone market has been fierce pushing down prices and cutting margins. He said that BenQ might consider investment in

other low-cost locations such as India or Southeast Asia if a revaluation of the Renminbi increases costs in the PRC.  
PAAL